Testimony Before the Committee on Finance

United States Senate

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Hearing on Comprehensive Tax Reform: Prospects and Challenges

Mr. Chairman, Senator Wyden, and distinguished members of the Committee:

Thank you for the opportunity to testify today on tax reform. I had the privilege to testify before this Committee in March 2011, with other former Assistant Secretaries for Tax Policy. We testified on how changes since the Tax Reform Act of 1986 have affected the tax code. That hearing was one of a series of hearings held by Congress to advance the process of reforming our tax system.

For many years policymakers have expressed a desire to reform the Internal Revenue Code. Much has changed since the last major overhaul in the Tax Reform Act of 1986. All of us recognize that updating the Code is a necessity. We hope we are at a climax in this effort, and that in the coming months we will see the enactment of significant reform.

As I stated in my 2011 testimony, the primary purpose of the federal tax system is to collect the revenues needed to fund the government. We would all agree that goals of an optimal tax system would include promoting economic growth, minimizing distortions and supporting the competitive position of American businesses around the globe. Another goal is that our tax system should be as simple as possible, fair and stable. It should also be administrable for individual and business taxpayers as well as for the Internal Revenue Service. Our current tax system is suboptimal in achieving these goals.

We live in a constantly changing world. Economic, social and political developments, including accelerating advancements in technology, are changing our nation and its role in world affairs and the global economy. As the global economy evolves, we need to re-evaluate our tax laws to ensure they are responsive to current and anticipated domestic and global conditions. We must also recognize that our tax system does not operate in a vacuum – it is one of many tax systems around the world, and as other countries revise their tax systems, we must respond as necessary to ensure that our tax system is in the best possible position to facilitate outbound and inbound investment and maximize the welfare of the American people.

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Numerous tax bills have been enacted since 1986. The Internal Revenue Code is a patchwork of provisions serving a wide variety of purposes. As the Code grows, and the regulatory and administrative guidance interpreting and implementing the Code also grows, our enormously complex tax system becomes even harder for taxpayers to understand and for the IRS to administer.

The debate about tax reform has been ongoing for over a decade. Extensive groundwork has been laid by the work of policymakers, academics, taxpayers and practitioners. It is now essential to take the next step and enact tax reform that, among other things, reduces tax rates, eliminates various preferences, modernizes the international tax system, and helps American workers and families. If possible, the reforms should be permanent. In addition, tax reform should be distributionally neutral, so the relative burden of income taxation does not shift.

All of this should be achieved in a fiscally responsible manner. Everyone is aware of the long-term fiscal challenges our nation faces as spending, especially mandatory spending, continues to increase. We need to reform our tax system in a manner that does not disadvantage us in addressing our long-term budget imbalances.

Despite the challenges in designing a new system, we have an opportunity we do not want to miss. There will necessarily be compromises along the way, but the most important objective is to enact tax reform that moves the tax law in the proper direction. As quickly as possible, it is important to enact legislation that will end uncertainty that could deter business and investment activity. Tax reform will provide benefits to American businesses, workers and families. There is a window of opportunity now, and it is important to act before that window shuts.

Why Tax Reform?

The reasons for tax reform are well known. Some of the reasons for tax reform include:

(1) *An evolving business and global landscape*. The U.S. economy is very different than it was at the time of the Tax Reform Act of 1986, the last major overhaul of the Internal Revenue Code. The world economy and the U.S. role in that economy is vastly different than it was in 1962, when the basic structure of our international tax system was enacted. The U.S. economy is increasingly integrated and interdependent with the economies of other nations. Both capital and labor have become increasingly mobile. Traditional manufacturing has declined in relative size, while technology, services, financial innovation and intangible assets have become more important. It is necessary to reform the Code in light of these significant changes.

(2) *Increasing global competitive pressures*. While the Code has grown in size and complexity, its structure generally has remain unchanged over the past several decades. In contrast, other countries have responded to increased global competition, lowering their corporate tax rates and shifting to territorial tax systems. Taxes are one factor businesses consider in deciding where to locate their activities. Businesses take into account other factors as well, such as labor costs and political and financial stability. As its competitive edge in other factors narrows, the United States must adapt its tax system to meet global competition.

(3) *The inclusion of many special provisions in the Code*. The Internal Revenue Code does much more than raise revenue necessary to fund the federal government. The Code contains many provisions for individuals and businesses that address social and economic policy issues. As a result, the Code has grown enormously and is increasingly complex. Because of special provisions, the Code taxes some taxpayers at high effective rates and others at much lower effective rates. It is necessary to reform the Code to simplify it and remove distortions. Simplification would make it easier for individuals and businesses to comply with their tax obligations and would make it easier for the IRS to administer the law. A simpler Code would improve taxpayer perceptions regarding the fairness of the tax system.

(4) *Inadequacies of the U.S. international tax system*. The United States has a unique international tax system that provides for deferral of tax on active foreign earnings until they are repatriated to the United States. Most other countries have adopted a territorial tax system, which generally exempts from tax earnings from foreign operations. The high U.S. corporate tax rate and repatriation tax encourage U.S. companies to move activities offshore and keep the earnings offshore (the so-called "lockout effect"). The U.S. international tax system also creates an incentive for U.S. companies to use transfer pricing among affiliates to shift income to lower-tax jurisdictions. Furthermore, it creates an incentive for U.S. companies to engage in inversions. It is necessary to reform the Code to address these international tax problems.

(5) *Incentives to use debt financing*. The current U.S. tax system favors the use of debt financing rather than equity financing. Business interest expense is deductible, whereas dividend payments are not. The deduction for interest creates an incentive for businesses to borrow more than they otherwise would, increasing the risk of financial failure. The tax law should be made more neutral in its treatment of debt and equity.

(6) *The need for stronger economic growth*. It is important to increase the rate of economic growth in the United States. Economists agree that faster write-off of capital investments promotes economic growth by encouraging such investments. Lower tax rates will also promote growth. Higher economic growth will help U.S. businesses, workers and families.

Key Issues to Address

In designing a tax reform package, there are a number of important issues that need to be addressed. The following is a discussion of ten issues. Many of the issues are interrelated and decisions about an issue will affect decision-making about other issues.

1. *Should tax reform be revenue neutral? What baseline should be used to measure this? What scoring method?*

Congress will need to decide whether to make tax reform revenue neutral. In making this decision, Congress must select a baseline and a scoring method.

There are two options for a baseline, a current law baseline or a current policy baseline. A current law baseline assumes that current law will continue to apply, including future changes in the law already enacted, such as expiring provisions. A current policy baseline assumes that various expiring provisions will be extended.

Congress must decide whether to use conventional or dynamic scoring. Conventional scoring assumes a fixed gross national product (GNP). Dynamic scoring takes into account the effect of significant tax changes on GNP and the resulting effect on tax revenues.

If the reconciliation process is used for tax reform, no title of the bill can lose revenue outside the budget window; otherwise the title will be subject to a point of order requiring 60 votes. If the point of order is not overcome, the title will be stricken from the bill. To avoid this, provisions can be designed to sunset at the end of the budget window and not lose revenue outside the budget window. Congress would need to select a budget window for this purpose – ten years or perhaps longer.

If the point of order is overcome by obtaining 60 votes or if the reconciliation bill is revenue neutral outside the budget window, it can be permanent. Permanence provides tax certainty for business and investment decision-making. In addition, a revenue-neutral bill has less potential to worsen our country's long-term fiscal imbalance. However, maintaining revenue neutrality would prevent tax reform from providing greater benefits, such as a greater reduction in the U.S. corporate tax rate to make it more competitive with tax rates in other countries.

In addition to revenue neutrality, distributional neutrality is an important consideration in tax reform. Distributional neutrality ensures that no particular income class receives an advantage over another.

2. How much can tax rates be lowered?

The resolution of the question of how much tax rates can be lowered depends in large measure on whether tax reform would be revenue neutral, what deductions, credits and other provisions would be eliminated for individuals and businesses, and what revenue raisers would be included. It is anticipated that a broader income tax base would remove distortions, resulting in a more efficient system fostering improved economic growth.

How much the U.S. corporate income tax rate can be lowered is a critical question for business tax reform. Today the United States has one of the highest statutory corporate income tax rates in the world (35% plus state corporate taxes). Over the years other countries have lowered their corporate tax rates significantly below the U.S. rate. This disparity in rates encourages U.S. companies to move activities overseas, and the U.S. deferral system of international taxation that imposes a tax on repatriated earnings encourages U.S. companies to keep their active foreign earnings offshore. The disparity in tax rates also encourages U.S. companies to engage in inversions to reduce their U.S. tax burden.

A substantial reduction in the U.S. corporate tax rate would lessen the incentives described above. The greater the reduction, the more those incentives would be diminished.

3. What deductions, credits and other provisions should be eliminated?

Selecting individual and business deductions, credits and other provisions to eliminate will be a difficult process. Over the years many provisions have been added to the Code to address social or economic issues. The deduction for home mortgage interest was enacted to encourage home ownership. The charitable deduction was enacted to encourage charitable giving. Many special provisions, such as the research credit, encourage activity that has favorable spillover benefits that benefit more than the taxpayer engaging in the activity.

4. Should tax reform include a territorial system? With base erosion provisions?

Most other countries have adopted a territorial tax system, which generally exempts from tax the active earnings from foreign operations. As indicated above, the United States has a unique international tax system that permits deferral of tax on active foreign earnings until they are repatriated to the United States. The repatriation tax puts a U.S. multinational at a disadvantage compared to a multinational company from a territorial

country with respect to operations in a third country. The multinational from a territorial country is not subject to a repatriation tax on income earned in the third country.

If Congress enacts a territorial tax system where active foreign earnings are generally not subject to U.S. tax even when repatriated to the United States, there will be continuing incentives to shift activities from the United States to low-tax jurisdictions. Commentators generally agree that base erosion provisions must be included in tax reform to combat this shifting.

Several possible base erosion provisions have been suggested, including for example a proposal to tax "foreign base company intangible income" in Chairman Camp's Tax Reform Act of 2014, the Obama Administration's proposal for a minimum tax on foreign income in the 2012 Framework for Business Tax Reform, and the border adjustments proposed in the House Republican Blueprint.

It is anticipated that international tax reform would include a deemed repatriation provision that would impose a tax on unrepatriated foreign earnings. There is more than $2 trillion of unrepatriated foreign earnings held by U.S. multinationals. The tax rate on the deemed repatriated amounts might vary depending on whether the offshore earnings are invested in liquid assets or invested in other assets such as plant or equipment. Issues include how the amount of unrepatriated foreign earnings would be calculated, at what point in time they would be calculated, and how the earnings would be allocated between liquid assets and other assets.

5. Should tax reform include border adjustments?

Using a cash-flow based approach for businesses applied on a destination basis, the House Republican Blueprint would exempt from U.S. tax products, services and intangibles that are exported outside the United States regardless of where they are produced. Products, services and intangibles that are imported into the United States would be subject to U.S. tax regardless of where they are produced. Stated another way, income from exports would be exempt from tax (but associated deductions would be permitted), whereas deductions for imports would be denied (but associated income would be taxable).

Border adjustments would have the advantage of reducing incentives to move or locate operations outside the United States, because products exported from the United States would be exempt from U.S. tax just like products produced outside the United States. Border adjustments would also raise a substantial amount of revenue, because the United States is a net importer.

U.S. companies that import a significant portion of their inputs fear that their tax burden would increase substantially as a result of border adjustments (the same amount of

income with substantially fewer deductions). Some economists assert that, because of correlative adjustments in exchange rates (or price levels or wages), border adjustments that are symmetrical as to exports and imports would not harm importers and would not result in a change in the levels of U.S. exports and imports or the balance of trade.

Under this reasoning, denial of deductions for imports would raise the U.S. cost of imports and consequently reduce U.S. demand for them. This would result in an increase in value of the dollar as compared to other currencies (because of weaker U.S. demand for imports), which would reduce the cost of imports, mitigating the reduction in U.S. demand for them. Similarly, the exclusion of income from exports would lower the U.S. cost of exports and increase foreign demand for them. This would result in an increase in the value of the dollar as compared to the currencies (because of stronger foreign demand for U.S. exports), which would make U.S. exports more expensive for foreigners, mitigating the increase in foreign demand. As a result of the currency adjustments, for importers the lower cost of imports would offset the additional tax from the denial of deductions for imports, and for exporters the reduced tax from the exclusion of income from exports would be offset by reduced revenue from exports.

There has been considerable debate about how these adjustments would operate in actual practice, including how quickly the relative value of the U.S. dollar would adjust, and whether the effect of the anticipated increase in the relative value of the U.S. dollar on the cost of imports would completely offset the tax increase for importers.

Furthermore, there are various uncertainties in the border adjustments as outlined in the House Republican Blueprint. For example, it might be relatively clear how to identify export income or import expenses related to tangible goods, but it is not as clear for income and expenses from intangibles and services. Also, special rules would be required for financial institutions.

Moreover, it is not clear whether the border adjustments as outlined in the House Republican Blueprint would comply with World Trade Organization rules. Irrespective of WTO issues, it is uncertain how other countries might respond if the United States were to enact such border adjustments. It is also uncertain how U.S. bilateral tax treaties would apply to the border adjustments and whether the border adjustments would violate treaty obligations.

Finally, an increase in the relative value of the U.S. dollar would increase the value of U.S. assets held by foreigners and decrease the value of foreign assets held by U.S. persons.

6. Should tax reform include limitations on the deductibility of interest expenses?

As previously discussed, the current tax system favors the use of debt financing rather than equity financing because business interest expense is deductible, whereas dividend payments are not.

Over the years there has been considerable discussion of corporate integration as a means to eliminate the distortions caused by the double tax imposed by the U.S. corporate tax system (tax on earnings at the corporate level and a second tax on shareholders with respect to dividends and capital gains). The distortions include: (1) the incentive to use pass-through businesses (partnerships, limited liability companies or S corporations) or sole proprietorships rather than C corporations, (2) the incentive for corporations to use debt financing rather than equity financing, (3) the incentive for corporations to retain earnings and not pay dividends, and (4) the incentive for corporations to pay out earnings in ways other than dividends (such as the payment of deductible compensation, interest, rent or royalties).

Corporate integration could equalize the treatment of debt and equity financing for tax purposes (for example by making dividend payments deductible like interest payments) or make their tax treatment more symmetrical (for example by providing a dividend exclusion for shareholders, so that dividends would be nondeductible and not includible in income, whereas interest payments would be deductible and includible in income). In 1992 the Treasury Department issued a study about various options for corporate integration. More recently, in December 2014 the Republican Staff of the Senate Finance Committee released "Comprehensive Tax Reform for 2015 and Beyond," which includes an extensive discussion about corporate integration.

There are a number of potential options for limiting deductions for business interest expenses, including for example: (1) denying a deduction for net interest expense, as proposed in the House Republican Blueprint, (2) disallowing net interest expense to the extent it exceeds a formulaic amount (for example, in excess of a certain percentage of income), or (3) disallowing net interest expense to the extent the ratio of U.S. interest expense to U.S. income exceeds the worldwide ratio for the company's corporate group, as proposed in Chairman Camp's Tax Reform Act of 2014. If tax reform includes a provision limiting interest expense, special rules would be necessary for financial institutions, such as banks.

7. How should tax reform deal with cost recovery?

The House Republican Blueprint proposes immediate cost recovery for investments in both tangible property (such as equipment and buildings) and intangible assets (such as intellectual property). It would not apply to land.

Economists believe that expensing would encourage business investment and result in significant economic growth. However, expensing cannot be combined with interest deductions – otherwise there would be a negative tax rate on leveraged capital investments.

There are various taxpayers who are not enthusiastic about expensing and would prefer retention of a deduction for business interest expenses. For example, purchasers of land, which would not qualify for expensing, would like to continue to deduct interest expenses on the debt used to acquire the land. In addition, small businesses already have expensing under Section 179 and would prefer not to lose a deduction for interest expenses. Also, many businesses are satisfied with 50% bonus deprecation.

8. How should tax reform deal with pass-through entities?

The treatment of income earned by pass-through entities, such as partnerships, limited liability companies and S corporations, raises challenging issues. It is expected that income earned by pass-through entities would be taxed at a lower rate than compensation income. The reason for this proposal is that the tax rate for corporate income would be reduced, so therefore similar business income earned by pass-through entities should also benefit from a reduced tax rate.

It is anticipated that the benefit of the lower rate would not be available for income earned by a pass-through entity related to an owner's performance of services. The basis for this exclusion is the concern that the tax that would otherwise be owed on compensation income should still apply if business is conducted through a pass-through entity.

Exactly how this system for pass-through entities would operate is not clear. Presumably income earned by a pass-through entity would be divided into different parts (such as business or investment income). Each owner's distributive share of business income would be taxed at the lower rate, except that some portion (or all) of this distributive share would be taxed as compensation if the partner materially participates in the entity's operations. An owner's compensation portion taxable at higher rates could be calculated in one of several ways, such as: (1) an amount equal to "reasonable compensation," (2) the entire distributive share reduced by a return on capital contributed by the owner to the entity, or (3) a fixed portion of the distributive share (say 70%).

Similar issues are also presented by earnings of sole proprietorships. Because there is no legal separation between a sole proprietorship and its owner, rules would need to separate the owner's business activity from other activity and further separate income taxable as compensation from income taxable at the lower rate.

9. What transition rules should be included?

Consideration would need to be given to transition issues. For example, if full expensing is enacted, how would property placed in service before enactment be treated? Would continuing depreciation deductions be permitted for property placed in service before enactment? Would deductions be phased out over time?

If limitations on deductibility of interest expenses are enacted, how would debt incurred before enactment be treated? Would continuing interest deductions be permitted? Would deductions be phased out over time?

Transition rules would soften the impact of new rules on pre-enactment activity. However, transition rules could delay or lessen the anticipated benefits of tax reform.

10. How would tax reform restructure the Internal Revenue Service?

The House Republican Blueprint calls for remaking the IRS into a streamlined organization dedicated to delivering world-class customer service. Our tax system relies on voluntary compliance. Voluntary compliance depends in large measure on the belief of the American people that the tax law is equitable and is administered fairly. Any restructuring of the IRS should make sure the agency has the capability, both in services and enforcement, to collect the revenues called for by law in a fair, consistent and efficient manner using modern information technology.

Conclusion

The list of issues that must be addressed may appear to be daunting. Nevertheless, there is a pressing need to make our tax system better. We need to take advantage of our window of opportunity before it shuts.

In March 2011, I closed my testimony before this Committee by referring to the story in Greek mythology about the fifth labor of Hercules. His task was to clean the Augean stables, which had not been cleaned in 30 years. More than 30 years have passed since the Tax Reform Act of 1986. We need to complete the Herculean task of reforming the Internal Revenue Code.